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1992

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Recommended Citation
Benjamin Weintraub and Alan N. Resnick, *From the Bankruptcy Courts: Making a Bad Check Good -- Preference Risks Caused By Bounced Check*, 25 UCC L.J. 83 (1992)
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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

MAKING A BAD CHECK GOOD—PREFERENCE RISKS CAUSED BY BOUNCED CHECK

Every lender has experienced the disappointment and anxiety that results when a check received as a payment in the ordinary course of business is returned by a debtor's bank because of insufficient funds. The concern may be aggravated to a feeling of alarm if, when the check was received, the lender had released a security interest in the debtor's goods. Of course, whether or not the lender has a security interest in the debtor's assets, a lender holding a bounced check often is relieved when the debtor either replaces the bad check with one that is honored by the bank or effectuates payment by cash or wire transfer.

However, as illustrated by the recent decision of the Court of Appeals for the Fourth Circuit in *In re Barefoot*,[1] a lender who is unsecured, or who had released its security interest upon receiving the debtor's original check, may not take too much comfort in the fact that payment is effectuated subsequent to a check being dishonored. Such payment may be recoverable as a voidable preference under Section 547 of the Bankruptcy Code[2] if the debtor becomes the subject of a voluntary or involuntary bankruptcy petition within the next ninety days. In fact, the dishonoring of the check may itself expose the subsequent payment to attack as a preference despite the fact that, if the check had been paid when first presented, such payment would not have been a voidable preference.

In *Barefoot*, the debtor, doing business as D&M Mobile Home (D&M), entered into a floor plan financing agreement with Champion Credit Corporation (Champion) pursuant to which Champion loaned money to D&M to enable it to purchase mobile homes from Champion Home Builders to be resold to consumers. Champion took a purchase money security interest in a portion of D&M's inventory that it had financed, as well as in the proceeds of that inventory. Although Champion had reserved the right to demand payment at an earli-

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[1] 952 F.2d 795 (4th Cir. 1991).

[2] 11 U.S.C. § 547.

er time, D&M agreed to pay off the loans as it sold each unit. Champion also held the certificate of origin for each mobile home as the means of perfecting its security interest, and it did not release any certificate until D&M repaid the outstanding indebtedness for the relevant mobile home.

On April 20, 1987, Champion received a check from D&M for the sum of $133,538 in payment of the amounts owed in connection with five mobile homes that D&M had sold to customers. Champion released the five certificates of origin for the mobil homes, thereby releasing the security interests in those homes, before learning on April 30 that D&M's check had bounced. This was the first time that a check drawn by D&M to Champion had been dishonored. To make up for the bounced check, D&M sent Champion's parent company, Chrysler First Commercial Corporation (Chrysler First), three wire transfers totaling the sum of $109,664.07. The wire transfers were sent on May 13, May 29, and June 3, 1987.

On August 5, 1987, an involuntary chapter 7 petition was filed against D&M, and the trustee commenced an adversary proceeding against both Champion and Chrysler First seeking to set aside the three wire transfers as preferences occurring within ninety days of the filing of the bankruptcy petition. After conducting an evidentiary hearing, the bankruptcy court ruled in favor of the trustee and ordered the return of the $109,664.07 plus interest. On appeal, the district court affirmed the bankruptcy court's decision.

The issue before the court of appeals was whether payment by a debtor to an unsecured creditor, or to a secured creditor who had released its security interest prior to such payment, made within ninety days of bankruptcy, constitutes a voidable preference under Section 547(b) of the Bankruptcy Code where the purpose of the payment was to "cure" a dishonored check of the debtor that, if honored when originally presented, would not have been a voidable preference. The bankruptcy court, district court, and court of appeals all ruled that the payments were recoverable as voidable preferences.

The court of appeals began by citing Section 547(b) as the source of the bankruptcy court's power to avoid preferential transfers to creditors:

> Two purposes animate this statutory avoidance power. First, the avoidance power promotes the "prime bankruptcy policy of equality of distribution among creditors" by ensuring that all creditors of the same class will receive the same pro rata share of the debtor's estate. . . . Second, the avoidance power discourages creditors from attempting to outmaneuver each other in an effort to carve up a financially unstable debtor and offers a concurrent opportunity for the debtor to work out its financial

difficulties in an atmosphere conducive to cooperation.[3]

Elements of a Preference

The court then listed the six elements that must be present for a transfer to be avoided under Section 547(b):

> The transfer must have been (1) of an interest of the debtor in property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt owed by the debtor before the transfer was made; (4) made while the debtor was insolvent; (5) made on or within ninety days of the filing of the bankruptcy petition; and (6) it must enable the creditor to receive a greater percentage of its claim than it would under the normal distributive provisions in a liquidation case under the Bankruptcy Code.[4]

Champion took the position that several of the elements of a preference have not been proven. First, it argued that the date of the delivery of the check should be considered the date of the transfer and, therefore, the transfer in this case took place prior to the ninety-day preference period. Champion cited a number of decisions of the Fourth Circuit for the proposition that the date of delivery of the check operated to fix the time of transfer.[5] "Champion, however, overlooks the critical fact that in each of those cases, the check at issue had been honored when presented for payment. When a check bounces, the date of delivery of the dishonored check no longer determines the time of transfer for the purpose of § 547(b)."[6] The court reasons that the rationale for the "date of delivery" rule, which has been adopted in several jurisdictions including the Fourth Circuit and which has been rejected in others, is that in the commercial world, payment by check is often viewed as the end of a commercial transaction. "The delivery of a bounced check, however, can in no way be deemed the end of a commercial transaction. Indeed, the transfers in this case which ended the transaction were the wire transfers which clearly took place within the ninety-day preference period."[7]

Referring to Champion's position, that the date of delivery of the dishonored check determines the

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[3] 952 F.2d at 797–798, quoting from H.R. Rep. No. 595, 95th Cong., 2d Sess. 177–178 (1978).

[4] 952 F.2d at 798. The court did not mention the fact that the preference period is extended to one year prior to bankruptcy if the creditor is an insider. See 11 U.S.C. § 547(b)(4).

[5] Champion cited *In re* Virginia Information Sys. Corp., 932 F.2d 338, 341–342 (4th Cir. 1991) (involving date of transfer under § 547(b)); Quinn Wholesale Inc. v. Northen, 873 F.2d 77, 78 (4th Cir. 1989) (involving avoidance powers of trustee for post-petition transfers under 11 U.S.C. § 549(a)(1)); *In re* Continental Commodities Inc., 821 F.2d 527, 530 (4th Cir. 1989) (involving former forty-five-day limit for § 547(c)(2) ordinary-course-of-business exception to preference avoidance).

[6] 952 F.2d at 798. The court of appeals cited *In re* White River Corp., 799 F.2d 631, 634 (10th Cir. 1986); *In re* Global Int'l Airways Corp., 80 Bankr. 990, 995 (Bankr. W.D. Mo. 1987).

[7] 952 F.2d at 798.

time of transfer, the court observed that such interpretation would have the anomalous effect of giving operative legal significance to dishonored checks, and would also undermine both policies underlying Section 547(b):

> First, favoritism of certain creditors with payments making good bad checks deals a serious blow to the fundamental bankruptcy policy of equality of distribution among members of the same class. . . . Second, creditors may possess greater incentives to forsake cooperative arrangements involving financially troubled debtors if the delivery date of dishonored checks is to become the operative one under bankruptcy preference law. With the insufficiency of funds in a debtor's account less of an immediate constraint, creditors may be tempted to demand payment from a debtor on the edge of bankruptcy rather than negotiate a work-out plan on the grounds that even a bad check might later be made good without risking avoidance of the payment as a preference.[8]

Several other arguments were presented by Champion in support of its position that the elements of a preference were not established, but they were quickly dismissed by the court with little discussion. Champion argued that the wire transfers were not transfers of the debtor's property because they were proceeds from the sale of the mobile homes held in trust for Champion by D&M. However, the court responded by noting that "the argument was not raised at the trial level, has no relevant legal authority in support of it, and overlooks the fact that this is nothing more than a traditional debtor-creditor relationship in which the indicia of a trust are not present."[9]

The court similarly dismissed the argument that the payment was not on account of an antecedent debt because the debt is not incurred until it becomes due and payable. That is, as long as the debt is paid when due, it is not a preference. The court noted that a debt is incurred when the debtor first becomes legally obligated to pay. Here, D&M became obligated to pay as soon as it received an advance for the purchase of a mobile home, not later when the home is sold and repayment is to be made.

The court also addressed Champion's position that the final element of a preference under Section 547(b)(5)—that the creditor receive more as a result of the transfer than it would have received if the transfer had not been made and had the debtor filed a chapter 7 petition—was not present. It is clear that a properly perfected and fully secured creditor that receives payment shortly before bankruptcy is not receiving a preference because it would have received full payment in chapter 7 in any event. There is also no dispute that if Champion is considered an unsecured creditor at the time of the payment, the wire transfers enabled

[8] 952 F.2d at 798–799.

[9] 952 F.2d at 799.

it to receive more than it would have received in a chapter 7 case due to the debtor's insolvency. The court concluded that Champion was not a secured creditor at the time of the payments in question because it had released its security interest in the mobile homes prior to the date of the wire transfers.

Once the elements of a preference are established under Section 547(b), the creditor may assert any of the defenses set forth in Section 547(c). Champion raised two exceptions to preferences as defenses, but both were rejected by the court of appeals.

The Contemporaneous Exchange for New Value Exception

Champion argued that, even if all the elements of a preference had been proven, the wire transfers were a contemporaneous exchange for new value given to the debtor which is protected from avoidance pursuant to Section 547(c)(1).[10] It reasoned that the release of the security interest in the five mobile homes in exchange for D&M's bad check constituted a contemporaneous exchange for new value. However, the court concluded that the only payments that were made were the wire transfers that took place within the ninety-day preference period. These payments within the preference period were not contemporaneous with the release of the certificates of origin that occurred before the preference period. "Indeed, to relate the wire transfers back to the time of the certificates' release in order to make the exchange contemporaneous is to accord the very operative legal significance to the bad check we have rejected in the preceding section."[11]

More important, the court wrote that "when a bounced check is given by the debtor in exchange for new value provided by a creditor, any subsequent payment to make good the bad check is not a contemporaneous exchange for new value."[12] The contemporaneous-exchange exception does not ordinarily apply to credit transactions, but it is intended to protect contemporaneous exchanges in which a check is used for payment as a cash equivalent:

> Unlike the case of an honored check or a cash payment where there is only one exchange between the debtor and creditor, the case of a dishonored check involves multiple exchanges and thus assumes the character of a credit transaction: the debtor gives the bad check, which in this context

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[10] See 11 U.S.C. § 547(c)(1). Section 547(a)(2) provides that "new value" means

> money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.

[11] 952 F.2d 800.

[12] 952 F.2d at 800. The court cited *In re* Standard Food Servs, Inc., 723 F.2d 820, 821 (11th Cir. 1984) (cashier's check making good a bounced check held not a contemporaneous exchange for new value).

is the functional equivalent of a promissory note, followed by one or more payments to make good the check. The dishonor of a check, therefore, defeats the actual achievement of a contemporaneous exchange for new value, and we conclude that any payments to make good a bounced check cannot qualify as transfers to which the contemporaneous exchange exception applies.[13]

Bouncing a Check Not in Ordinary Course of Business

Champion also argued that the ordinary course of business exception set forth in Section 547(c)(2) protects the wire transfers from avoidance by the trustee.[14] For this exception to apply, the creditor must prove, among other things, that the transfer was made in the ordinary course of business or financial affairs of the debtor and the transferee. Champion attempted to persuade the court that it was the ordinary course of business for it to release the relevant certificates of origin upon receipt of D&M's checks and that the court should not distinguish between the receipt of good checks and the receipt of bad checks for this purpose. It also argued that the wire transfers merely represented a delayed honoring of the check and that, therefore, the wire transfers should not be the focus of the ordinary course inquiry.

The court rejected the position that a bounced check and subsequent payments to make it good may be viewed as the ordinary course of business. Citing the legislative history of the Code, the court noted that the purpose of the ordinary course of business exception is to leave normal business relations undisturbed when there is no unusual action taken by either the debtor or the creditor. Again emphasizing its concern that bounced checks should not be encouraged, the court of appeals wrote:

> Quite apart from the fact that the bankruptcy court found that "the dishonoring of the check was a deviation from the ordinary course of business between the parties" and that the subsequent wire transfers represented an uncustomary medium of payment, to allow parties to benefit from writing or receiving bad checks would almost certainly result in a greater number of such checks being passed. One can hardly imagine anything that would be more disruptive of "normal financial relations" between troubled debtors and their creditors than affording dishonored checks the imprimatur of law.[15]

In a concurring opinion, Judge Widener went even further than the majority opinion in that he would not base affirmance on the conclusion that the bankruptcy court was not clearly erroneous in its factual finding that the conduct of the parties was not the ordinary course of business in this case. Widener, suggesting adoption of a per se rule, voted to affirm because Congress did not intend that making a bad

[13] 952 F.2d at 800.

[14] See 11 U.S.C. § 547(c)(2).

[15] 952 F.2d at 801.

check good should be protected by the ordinary course of business exception under Section 547(c)(2), regardless of whether it has occurred in the past. "To rely on the factual determination of the courts below in the circumstances present here may suggest that if the parties had gone through like factual situations on previous occasions in making bad checks good, a finding of ordinary course of business or financial affairs might have been sustained. I do not think that is the case."[16]

Equities Do Not Favor Creditor

Champion's final argument was that the equities of the situation demanded that it be allowed to retain the payments made by wire transfer. Champion had no way of knowing that D&M was in financial trouble, and claimed that it was powerless to protect itself from the actions of D&M that resulted in the release of the security interest. Also, Champion emphasized that the wire transfers were intended only to replace the bounced check. "Thus Champion believes that treating it as an unsecured creditor would be a triumph of form over substance which would defeat the parties' intent."[17] The court was not persuaded.

> While we agree that Champion's position is unfortunate, we believe it is mandated under law. The avoidance of every preference will to some extent defeat the intent of the parties because the transferor was willing to make the transfer and the transferee was presumably willing to accept it.[18]

The court also commented that the adoption of Champion's position regarding the equities of the situation would require a court to make judgments on factual issues, including the (1) creditor's knowledge of the debtor's financial troubles; (2) reasonableness of the belief that the check was good; (3) intent of the parties in making the bad check good; and (4) reasonableness of the time of payment after the check bounced. The court noted that this approach would result in much litigation and that "it runs directly counter to the intent of the drafters of the preference provisions to eliminate these litigious inquiries in favor of a clear application of objective criteria."[19]

The court also rejected the contention that Champion was powerless to prevent the loss of its security interest. Champion voluntarily released the certificates of origin before waiting to see if the check had cleared. As the bankruptcy court stated,

> "Champion . . . is a sophisticated commercial lender which certainly understands the consequences of releasing collateral in reliance upon payment by check." In this case, Champion took a legal risk by releasing its security interest before being assured of payment, and regrettably

[16] 952 F.2d at 802.
[17] 952 F.2d at 801.
[18] 952 F.2d at 801.
[19] 952 F.2d at 801.

it must now accept the legal consequences.[20]

Conclusion

The court's decision in *Barefoot* contains no surprises. The court made it clear that a creditor who receives a check that bounces, but is subsequently made good by actual payment, may run the risk that the payment may be recoverable as a preference if the debtor files a bankruptcy petition within ninety days after the payment. The fact that there would have been no preference exposure had the check been paid when originally presented—because the creditor was fully secured at the time the check was delivered, the original delivery of the check was in the ordinary course of business, the check was delivered before the preference period, or the transaction would have been a contemporaneous exchange for new value—may not protect the subsequent payment from the reach of the trustee if the elements of Section 547(b) are present.

Finally, the court did not hesitate to warn secured creditors: "[T]he rule will serve notice to secured creditors to retain their security interests until payment is assured. . . ."[21]

[20] 952 F.2d at 802.

[21] 952 F.2d at 802.